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AN OPPORTUNITY MISSED: *ARMCO, INC. v. HARDESTY*, A RETREAT FROM ECONOMIC REALITY IN ANALYSIS OF STATE TAXES

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I. INTRODUCTION

In June of 1984, the United States Supreme Court decided *Armco, Inc. v. Hardesty*,[1] a case involving an Ohio manufacturer's commerce clause challenge to the West Virginia gross receipts tax. The *Armco* decision represents a step backward in the development of the Supreme Court's analysis of such challenges to gross receipts taxes to the extent that it returns to a formalistic, semantic approach to commerce clause analysis. The *Armco* decision represents a missed opportunity to apply the economics-based analysis of potential burdens on interstate commerce mandated by the Court's decision in *Complete Auto Transit, Inc. v. Brady*[2] and now consistently applied to test state net income taxes. The implications of this decision for state and local governments that tax businesses on a gross receipts, rather than a net income, basis are profound. Continued analysis on the artificial single-level basis applied in *Armco* may lead to the invalidation of a number of economically reasonable gross tax schemes.

It is the contention of the authors that a state gross receipts tax, like a state net income tax, must be reviewed for commerce clause purposes as an integrated system with an overall taxing goal. The appropriate analytic method has been available since *Complete Auto Transit v. Brady* was first applied to gross receipts taxes in *Department of Revenue of Washington v. Association of Washington Stevedoring Cos.*[3] That analysis involves a structured examination of the impact of the tax and of the relationship between the governmental entity seeking to impose it and the taxpayer in question. Application of the *Complete Auto Transit*

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[1] Armco, Inc. v. Hardesty, 104 S. Ct. 2620 (1984).

[2] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

[3] Department of Rev. of Wash. v. Association of Wash. Stevedoring Cos., 435 U.S. 734 (1978).

analysis by courts would encourage state and local governments seeking to impose gross receipts taxes to employ some scheme of apportionment that would seek to tax only that portion of a taxpayer's gross receipts from interstate activity that can be fairly attributed to the taxing jurisdiction. Under a gross receipts apportionment method, taxation may extend to activities conducted outside the taxing state.

Recognition of the correctness of this position requires an understanding of the nature of gross receipts taxes, an appreciation of their similarity to net income taxes, and an evaluation of the historical development of the commerce clause analysis applied by the *Armco* court. This Article will first describe the characteristics and use of gross receipts taxes, with special emphasis on how these taxes are similar in economic impact to net income taxes. The history of commerce clause analysis of these taxes will then be discussed in order to point out the sources of divergent analyses applied by the United States Supreme Court prior to *Armco*. This Article will conclude with an analysis of the *Armco* decision and its impact on taxing jurisdictions. It will be suggested that *Armco* was wrongly decided since there is no proper basis for treating gross taxes differently from net income taxes for purposes of commerce clause analysis. The authors will assert that only an apportionment requirement was needed to create a consistent, integrated framework for constitutional analysis of those taxes, and that the Court missed a perfect opportunity to establish such a framework.

II. Characteristics and Use of Gross Receipts Taxes

A gross receipts tax is an excise tax levied on business activities. The state statute or local ordinance imposing the tax typically refers to it as a tax on the act or privilege of doing business in the particular taxing jurisdiction. The West Virginia gross receipts tax statute, the statute that gave rise to the *Armco* decision, imposes a tax on selling activities in the State of West Virginia in the following terms:

> Upon every person engaging or continuing within this state in the business of selling any tangible property whatsoever . . . there is . . . hereby levied, and shall be collected, a tax equivalent to fifty-five one hundredths of one percent of the gross income of the business, except that in the business of selling at wholesale the tax shall be equal to twenty-seven one hundredths of one percent of the gross income of the business.[4]

The State of Washington's business and occupation tax is imposed in similar terms:

> There is levied and shall be collected from every person a tax for the act or privilege of engaging in business activities. Such tax shall be measured by the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be.[5]

A gross receipts tax is typically measured by the application of rates to the

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[4] W. VA. CODE § 11-13-2c (1983).

[5] WASH. REV. CODE § 82.04.220 (1983).

gross income of the business, whether gross proceeds of sales of goods or services or the gross value of products produced. It is not surprising, therefore, that the chief distinction commonly offered between state taxation of interstate sales on a gross receipts basis and on a net income basis is that the former tax is imposed on the seller-taxpayer regardless of whether the transaction yields a net profit. Closer examination of the taxing schemes of the states employing the gross receipts tax, however, indicates that profitability is, in fact, a significant consideration. In most jurisdictions, the gross receipts tax is applied at different rates on different business activities.[6]

The typical rationale offered for this rate differentiation is that certain business activities are generally operated on a greater margin of profit than others, therefore justifying a higher rate of tax.[7] In West Virginia, for example, retailing is taxed at 0.55%,[8] wholesaling at 0.27%,[9] manufacturing at 0.88%,[10] with other businesses taxed at still different rates.[11] The Washington gross receipts tax is imposed at nine different rates on various classifications of business activity, ranging from a low of 0.01% to a high of 30%.[12] In each case these tax rates were initially determined by the legislature after ascertaining the relative profitability of the business activities taxed. Moreover, profitability continues to influence tax rates because the lobbying efforts of various industries strongly influence legislatures, which frequently adjust tax rates as a specific industry's profitability wanes.[13]

In addition, in spite of its name, a gross receipts tax is normally applied with statutory deductions, adjustments, credits and exemptions. The Washington business and occupation tax statute provides for twenty-eight exemptions,[14] ranging from an exemption for international banking facilities[15] to an exemption for funds received in the course of commuter ride-sharing and ride-sharing for the elderly or handicapped.[16] Washington's gross receipts tax also provides for twenty-two different deductions,[17] ranging from a deduction for amounts which the state is pro-

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[6] *Compare generally* Dunn & Bradstreet Industry Norms and Key Business Ratios (1984-85 Library Ed.) *with* WASH. REV. CODE §§ 82.04.230-.290 (1983). *See, e.g.*, the net profitability percentages and gross receipts tax rate for real estate brokers (8.9%, 1.5%), newspaper printing and publishing (5.8%, 0.44%), and flour manufacturing (2.0%, 0.125%).

[7] *See* Judson, *Gross Receipts Taxes on Interstate Transactions*, N.Y.U. INSTITUTE ON STATE AND LOCAL TAXATION ¶ 1200 at n.12 (1983). Note, however, that proof of a profitability element in legislative decisions on gross receipts taxes is probably beyond the compentence of the judicial system.

[8] W. VA. CODE § 11-13-2c (1983).

[9] *Id.*

[10] W. VA. CODE § 11-13-2b (1983).

[11] W. VA. CODE §§ 11-13-2 to -2m (1983).

[12] *See* WASH. REV. CODE § 82.04.230-.0290 (1983).

[13] *See* Wash. Laws 1969 Ex. Sess., Chapter 262, § 36, in which the tax rate structure of WASH. REV. CODE ANN. 82.04.260 (1962) is substantially revised.

[14] *See* WASH. REV. CODE §§ 82.04.300-.427 (1983).

[15] WASH. REV. CODE § 82.04.315 (1983).

[16] WASH. REV. CODE § 82.04.355 (1983).

[17] *See* WASH. REV. CODE §§ 82.04.4281-.4298 (1983).

hibited from taxing under the United States Constitution[18] to a deduction for interest on loans secured by first mortgages on nontransient residential properties.[19] Moreover, under the Washington gross receipts tax scheme, certain manufacturers are permitted credits against tax for sales or use taxes paid in connection with the construction of new buildings or the enlarging of existing buildings used in manufacturing activities.[20] Many similar exemptions, deductions and credits are permitted by the West Virginia gross receipts tax statute, including an exemption for insurance companies,[21] as well as a credit for certain industrial expansion expenditures.[22] Indiana's gross receipts tax statute contains similar provisions.[23]

Because gross receipts taxes do, in many cases, seek to tax business activities in relation to their profitability, there is also an argument that such taxes, like state net income taxes, would be creditable for federal income tax purposes under certain circumstances. Pursuant to the Internal Revenue Code, only foreign income taxes are eligible for foreign tax credit; thus a gross receipts tax must be deemed an income tax in order for the credit to apply.[24] Gross receipts taxes are, thus, based on an economic rationale not dissimilar to that underlying net income taxes. The economic realities of these two different tax schemes do not appear to justify the divergent legal analyses currently employed by the Supreme Court when testing the constitutionality of gross receipts taxes in comparison with net income taxes. The widespread effects of continuing to apply a noneconomic analysis when reviewing commerce clause challenges to state or local gross receipts taxation of interstate sales should not be minimized. A number of states and municipalities utilize a gross receipts tax as a major revenue source. As indicated above, the States of West Virginia and Washington have broadly-based gross receipts taxes that provide a substantial portion of the revenues of those states.[25] Indiana utilizes a gross income tax as well as an alternative Internal Revenue Code-based income tax.[26] The Arizona

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[18] WASH. REV. CODE § 82.04.4286 (1983).

[19] WASH. REV. CODE § 82.04.4292 (1983).

[20] WASH. REV. CODE § 82.34 (1983).

[21] W. VA. CODE § 11-13-3 (1983).

[22] W. VA. CODE § 11-13-3c (1983).

[23] IND. CODE § 6-2.1-2-3 (1984).

[24] In Seatrain Lines v. Commissioner, 46 B.T.A. 1076 (1942), the Board of Tax Appeals determined that a gross receipts tax was an income tax for foreign tax credit purposes, in substantial part because the gross income tax rate had been set in order to accommodate some "average" business deduction rate which otherwise would have been available under a prior net income tax. The Internal Revenue Service, however, has not acquiesced in this decision. 1942-2 C.B. 31 (non-acquiescence in *Seatrain* decision). *See also* Rev. Rul. 78-233, 1978-1 C.B. 236 (Under I.R.C. § 901, creditable taxes are those taxes the purpose of which is to reach net gain and which are almost certain of doing so).

[25] For the fiscal year ending June 30, 1983, the Washington Business and Occupation Tax yielded $569,339,000 or 13.6% of the general revenues of the State of Washington. The West Virginia Business and Occupation Tax yielded $494,413,000 during the same period, or 33.6% of the State's general revenues. STATE TAX HANDBOOK (CCH) (1984) at ¶¶ 947-48.

[26] IND. CODE §§ 6-2-1-1 to -53, and §§ 6-3-1-1 to 6-3.5-5-18 (1984).

transaction privilege tax is nominally a gross receipts tax, but in fact it is intended to be passed on to the consumer and therefore more closely resembles a sales tax than a business income tax.[27]

Many states also impose taxes which closely resemble gross receipts taxes. The public utilities tax on gross receipts from business entities that engage in certain utility businesses is a popular revenue source.[28] Many states levy severance taxes, typically measured by the application of rates against the gross value of mineral or timber resources severed from the land.[29] Insurance companies are frequently taxed on a gross percentage of premiums, with certain limited deductions from that gross premium amount.[30] The State of Nevada levies a gross revenue tax on gambling establishments operating within the state.[31] All of these taxes are directly comparable to a broad-based gross income tax in that they are based on gross product of the business, with adjustments as permitted by statute.

This form of taxation is also growing in popularity among municipalities. The State of Washington authorizes its cities to impose gross receipts taxes that are very similar to the state tax.[32] The City of Seattle imposes such a tax, with exemptions, deductions and credits similar to the state scheme and with a variation in rate based on the nature and assumed profitability of a particular business activity.[33] The City of Los Angeles imposes a gross receipts tax upon many business activities conducted within its taxing jurisdiction.[34] This widespread use of gross receipts tax schemes by state and municipal taxing authorities suggests that the *Armco* decision will have a significant impact.

III. The Legal Context: Commerce Clause Review of State Taxation of Interstate Sales

A. *Gross Receipts Taxes*

Article I, section 8, clause 3 of the United States Constitution grants Congress the power to "regulate Commerce with foreign Nations and among the several States." The Supreme Court has interpreted this language to establish certain tests that must be met to sustain a state's efforts to tax a taxpayer engaged in interstate activity. The Court's decision in *Armco* demonstrates that the analysis regarding taxation of gross income produced by multistate operations has diverged from that

[27] Ariz. Rev. Stat. Ann. §§ 42-1301 to 42-1361 (1980).

[28] *See, e.g.*, Wash. Rev. Code § 82.16 (1983); Tex. Tax Code Ann. § 182.002 (Vernon 1982).

[29] *See, e.g.*, Wash. Rev. Code § 4814.020 (1983); Mont. Code Ann. §§ 15-23-802, 15-37-201 to -221 (1983).

[30] *See, e.g.*, Wash. Rev. Code § 48.14.020 (1983); Va. Code §§ 58.1-2501 to -2530 (1984).

[31] Nev. Rev. Stat. § 463.370 (1983).

[32] Wash. Rev. Code § 82.14 (1983).

[33] Seattle Wash. Code ch. 11.08 (1980).

[34] Los Angeles, Ca., Mun. Code art. 1, ch. 2 (4th ed. 1959).

employed when reviewing state taxation of income on a net income basis. It appears that the divergence derives at least in part from a refusal to address the economic realities of gross receipts taxation. This, in turn, may have originated in the somewhat artificial limitations established on gross receipts taxes by the states which enacted them.

Under most statutory schemes, a gross receipts tax is imposed only upon intrastate business. The Washington business and occupation tax statute, for example, imposes the tax on a "person engaging within this state in business. . . ."[35] Other state statutes have similar limitations.[36] In fact, this requirement of some local business activity is more restrictive than might be required by the due process or commerce clauses of the Constitution. Net income taxes, by contrast, are levied on taxpayers whose only contact with the taxing state is income derived from sources within the state.[37] No state which levies a gross receipts tax has attempted to date to extend its taxing jurisdiction by adopting such an approach.

At least two reasons have been suggested to explain the failure of gross receipts tax jurisdictions to broaden their statutory jurisdictional boundaries in such a manner.[38] Historically (and partly to avoid invalidation under the commerce clause), gross receipts taxes have been considered "privilege" taxes, levied by a state as a toll for the privilege of doing business within its boundaries. Since the taxes derive their economic and legal basis from this privilege rationale, the enabling statutes contain the jurisdictional requirement that the taxpayer engage in local business activity.

Another reason offered for the in-state business activity requirement is that gross receipts taxes are typically imposed on an "all or nothing" or unapportioned basis. If the tax applies, then all income derived from the particular business activity is fully taxed without any adjustment for the fact that the receipts being taxed may be generated by business activities in more than one state. Because the tax is imposed on the full measure of the taxpayer's local gross receipts without apportionment between the several states in which the taxpayer may operate, the gross receipts tax statute requires that the taxpayer have a clear and isolated business connection with the state.

These rationales led to the inclusion of the "doing business" requirement in most gross receipts taxes. That requirement, in turn, has had its natural effects on the development of the legal doctrine. Courts have applied a specific analysis

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[35] WASH. REV. CODE § 82.04.230 (1983).

[36] *E.g.*, IND. CODE § 6-2.1-2-2(2) (1984); N.M. STAT. ANN. § 7-9-4(A) (1984).

[37] Compare OR. REV. STAT. 317.070 (1983) (the corporation excise tax imposition provision) with OR. REV. STAT. § 318.020 (1983) (the corporation income tax. The excise tax imposes an income-based tax on business conducting activities within the state of Oregon; the income tax applies to corporations which derive income from sources within the state.

[38] *See* Judson, *supra* note 7, at § 1211.

to determine the validity of gross receipts taxes imposed on taxpayers engaged in interstate commerce. The analysis markedly restricts taxing authorities in gross receipts jurisdictions relative to those jurisdictions which impose net income taxes on multistate taxpayers. This special and, from the perspective of the taxing authority, undesirable treatment results, at least in part, from the express statements in the gross receipts tax statutes that the tax will be imposed only upon those engaged in local business. A review of the major United States Supreme Court decisions dealing with gross receipts taxation of interstate activities demonstrates, however, that, to a great extent, these special restrictions are the result of a continuation of a noneconomic formalism of analysis that, until *Armco*, the Court appeared to have abandoned in 1977 in *Complete Auto Transit.*

Early Supreme Court cases made it clear that gross receipts taxes could not be levied on interstate transportation because any such action would be an improper attempt to regulate interstate commerce.[39] The Court's analysis in the transportation cases was soon applied to other areas of interstate commerce. A state tax which constituted a "direct burden" on interstate commerce would be struck down as a violation of Congress' exclusive right to regulate interstate commerce.[40] The Court permitted no examination of the economic result of a particular tax scheme on a particular taxpayer, nor did it permit an inquiry into the actual impact of the tax on interstate commerce. If the tax was considered a "direct" burden on interstate commerce, it would be struck down; if the tax was considered to have only an indirect impact, it was allowed to stand.[41]

Western Livestock v. Bureau of Revenue[42] marked the rejection of fifty years of use of the "direct/indirect" test and the development of a new common sense approach to the commerce clause review of gross receipts taxes. The Court acknowledged that interstate commerce, like intrastate commerce, must "pay its way" by being subjected to state gross receipts taxes. The Court added a caveat that a particular interstate activity could not be burdened by multiple taxes for which an intrastate business would have no liability.[43] To implement this guiding principle, the Court adopted a "multiple taxation" test in which the validity of the tax depended on an analysis of whether the particular interstate activity could or might be exposed to multiple tax burdens imposed by successive state taxing authorities.[44]

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[39] *See* Fargo v. Stevens, 121 U.S. 230 (1887); Philadelphia & So. Mail Steamship Co. v. Pennsylvania, 122 U.S. 326 (1887).

[40] *See* Lockhart, *Gross Receipts Taxes on Interstate Transportation and Communication*, 57 HARV. L. REV. 40 (1943).

[41] *See, e.g.*, Crew Levick Co. v. Pennsylvania, 245 U.S. 292, 297-98 (1917) (direct burden); American Mfg. Co. v. St. Louis, 250 U.S. 459 (1919) (no direct burden).

[42] Western Livestock v. Bureau of Revenue, 303 U.S. 250 (1938).

[43] *Id.* at 259.

[44] *Id.*

The *Western Livestock* decision concerned the application of the New Mexico gross receipts tax to advertising revenues earned by a magazine publisher with a substantial interstate circulation. The Court noted that the interstate publishing activities of the taxpayer must bear their fair share of the cost of local government and that gross receipts from the advertising activity sought to be taxed by the State of New Mexico were unlikely to be subjected to a tax by any other state. The risk of multiple taxation was, thus, minimal or nonexistent, and the tax could stand.

Under the "multiple taxation" analysis, the Court viewed with disfavor gross receipts taxes imposed by the state of origin on interstate sales activity. In *J. D. Adams Manufacturing Co. v. Storen*[45] for example, Indiana applied its gross receipts tax to the sales income of a taxpayer who manufactured in Indiana but sold out-of-state. The Court struck down the tax on the unapportioned gross receipts of the taxpayer's out-of-state sales, noting that the state of destination could also tax those same revenues. To permit the state of manufacture to impose a tax on the sales receipts would constitute multiple taxation disfavored in *Western Livestock*.

One result of the Court's adoption and application of the multiple taxation analysis was that most states adopted a destination theory of gross receipts taxation, as opposed to an origin theory. Under the analysis developed by the Court, a tax could be levied on economic activity which terminated within the taxing state. A good example of the present-day application of the destination theory is the wholesaling tax imposed by the State of West Virginia on a taxpayer that manufactures in another state and ships its product to West Virginia where the product is sold at wholesale.[46] Under the artificial approach employed in analyzing gross receipts taxes, the wholesaling is deemed to occur entirely within West Virginia, even though it was preceded by a manufacturing activity in another state. The wholesaling activity can, therefore, legitimately be taxed by West Virginia, the destination state.

A destination theory of state taxation of sales receipts presented some revenue problems to states heavily populated with manufacturers for export. After *Adams*, such states sought another way to tax gross receipts of local manufacturing activity that preceded a wholesale or retail sale to a purchaser in another state. Their solution, soon validated by the Court, was simply to tax manufacturing rather than selling. In this scheme gross receipts were used simply as a measure of a tax imposed on local manufacturing activity where the manufactured goods were subsequently sold to purchasers in other states. Because of the artificial differentiation between various levels of business activity, the manufacturing taxes, like those related to sales, were applied on an unapportioned basis.

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[45] J.D. Adams Mfg. Co. v. Storen, 304 U.S. 307 (1938).

[46] *See* W. VA. CODE § 11-13-2c (1983) (imposing wholesaling tax on instate sales of manufactured articles; W. VA. CODE § 11-13-2b (1983) (imposing manufacturing tax on articles manufactured for sales outside state).

Application of the destination theory of gross receipts taxation of interstate sales activity received the Court's approval in *General Motors v. Washington.*[47] The case involved Washington's attempt to apply its business and occupation tax to the taxpayer's unapportioned proceeds of sales in Washington of motor vehicles and motor vehicle parts. Most of the taxpayer's business activities and all manufacturing activities took place outside the State of Washington. Although the taxpayer had a significant sales presence in Washington, only a small fraction of the value of the automobiles sold in the state related to the taxpayer's Washington activity. It was also clear that staff located in Michigan contributed significantly to the company's overall sales activity. The Court nevertheless authorized the full taxation by the State of Washington of all sales revenues generated from Washington customers on the destination sale principal.[48]

Though each of these developments represented an increasing recognition by the Court of the right of the states to tax participants in interstate commerce, the Court was slow to move in the direction of a practical and economically rational analysis of gross receipts taxes. Such an analysis is needed to test whether a particular state's gross receipts tax scheme actually taxes, or attempts to tax, only the value of an interstate activity properly attributable to the state in question. *Complete Auto Transit,* discussed below, appeared to signal the arrival of such an analysis. *Armco* calls that signal into question by setting up an artificial analysis which treats gross tax schemes differently than net income tax schemes.

B. *Net Income Taxes*

The early commerce clause analysis of state net income taxes suffered from the same mechanical, formalistic thinking as the analysis which was afforded gross receipts taxes. The early view of the Court was that a tax directly on interstate commerce, whether based on net income or otherwise, must necessarily violate the commerce clause, regardless of the sophistication of the apportionment method used by the taxing authorities.[49] An indirect tax, however, was permitted to stand.[50]

The direct/indirect line of cases continued to be applied to net income taxes over a period of fifty years.[51] *Northwestern States Portland Cement Co. v. Minnesota*[52] represented a step forward in holding that net income from the interstate operations of a foreign corporation may be subject to state taxation, provided the levy is not discriminatory and is properly apportioned to local activities within the taxing state to create a sufficient nexus to support the tax. A residual formality of analysis lingered, however. While a state could tax the apportioned

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[47] General Motors Corp. v. Washington, 377 U.S. 436 (1964).
[48] *Id.* at 449.
[49] *See, e.g.,* Robbins v. Shelby County Taxing Dist., 120 U.S. 489 (1887).
[50] *See, e.g.,* Postal Telegraph-Cable Co. v. Richmond, 249 U.S. 252 (1919).
[51] *See* 1 J. HELLERSTEIN, STATE TAXATION ¶ 4.6 (1983).
[52] Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959).

net income derived from exclusively interstate commerce, it could not tax the "privilege" of doing interstate business as measured by the apportioned net income.

The cases which had attached such dire constitutional significance to a purely semantic difference were overruled by the Court in *Complete Auto Transit*.[53] The case involved the attempts of the State of Mississippi to apply a tax on "the privilege of doing business" within Mississippi to a motor carrier who transported an out-of-state manufacturer's automobiles between points in the state. The Court overruled prior theories used to determine whether a particular taxing scheme violated the commerce clause, and adopted, instead, four economically sound criteria to determine whether the commerce clause invalidates a state tax. Under this analysis, four requirements must be met:

> 1. The activity must have a substantial nexus with the taxing authority;
>
> 2. The tax must be fairly apportioned;
>
> 3. The tax must not discriminate against interstate commerce;
>
> 4. The tax must be fairly related to services provided by the taxing jurisdiction.[54]

Complete Auto Transit thus mandates a structured examination of the impact of the tax and the relationship between the government entity seeking to impose the tax and the taxpayer. Commerce clause challenges to state net income taxes are now tested by these criteria.

C. *From* Complete Auto Transit *to* Armco

As noted previously, in deciding *Complete Auto Transit*, the Court rejected the anachronistic view that a tax on interstate commerce must necessarily violate the commerce clause, regardless of the apportionment method used by the taxing authorities. Purely formalistic tests of tax validity were rejected in favor of an inquiry into the substance of the relationship giving rise to the tax.

The tax at issue in *Complete Auto Transit*, denominated a "sales tax,"[55] was an excise tax levied on the privilege of engaging in business in Mississippi. In this case, the activity in question was transporting property between points in the state.[56] The measure of the tax was determined by applying rates against the gross proceeds of sales.[57] The taxpayer was a Michigan corporation engaged in the business of transporting vehicles by motor carrier for General Motors. The vehicles were assembled outside Mississippi by General Motors, shipped into Mississippi by rail

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[53] *Complete Auto Transit*, 430 U.S. 274.
[54] *Id.* at 277-78.
[55] *Id.* at 275.
[56] *Id.*
[57] *Id.*

and then loaded onto the taxpayer's trucks for delivery to Mississippi auto dealers.

When the State of Mississippi assessed taxes on the taxpayer's sale of transportation services, the taxpayer challenged the assessment on the basis that its transportation was but one part of a continuous interstate operation. The taxpayer relied on the court's earlier decisions holding that tax on the privilege of engaging in activity in the state may not be applied to an activity that is part of interstate commerce.[58] The Supreme Court reviewed its application of this rule which had looked only to the fact that the incidence of the tax is the "privilege of doing business" and which had deemed irrelevant any consideration of the practical effect of the tax. It also reviewed the line of cases flowing from *Western Livestock*. This line of cases turned not on the formal language of the statute, but rather on its practical effect. A tax was sustained against a commerce clause challenge when the tax was applied to an activity with a substantial nexus to the taxing state, was faily apportioned, did not discriminate against interstate commerce, and was fairly related to the services provided by the state.[59]

> Over the years, the Court has applied this practical analysis in approving many types of tax that avoided running afoul of the prohibition against taxing the "privilege of doing business," but in each instance it has refused to overrule the prohibition. Under the present state of the law, the Spector rule, as it has come to be known, has no relationship to economic realities. Rather, it stands only as a trap for the unwary draftsman.[60]

The *Complete Auto Transit* Court then rejected the Spector rule in favor of a rule which tests the economic consequence of a particular tax.

> Not only has the philosophy underlying the [Spector] rule been rejected, but the rule itself has been stripped of any practical significance. If Mississippi had called its tax one on "net income" or on the "going concern value" of the appellant's business, the Spector rule could not invalidate it. There is no economic consequence that follows necessarily from the use of the particular words, "privilege of doing business," and to focus on that formalism merely obscures the question whether the tax produces a forbidden effect. Simply put, the Spector rule does not address the problems with which the commerce clause is concerned.[61]

In order to address those commerce clause problems, nexus, apportionment, discrimination and relationship to services provided, the Court adopted the four requirements listed above.

The "substantial nexus" test requires that there be a substantial relationship between the state and the person, property or transaction that the state seeks to tax.[62]

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[58] *Id.* at 278.
[59] *Id.* at 279-87.
[60] *Id.* at 279.
[61] *Id.* at 288.
[62] *See* Miller Bros. v. Maryland, 347 U.S. 340, 345 (1954).

Nexus has, nevertheless, been found to exist on relatively slim facts. The requirement clearly does not involve anything approaching a majority of the taxpayer's business activity. In *Standard Pressed Steel Co. v. Washington*,[63] a gross receipts tax case, the taxpayer maintained one employee within the taxing state who was charged with the responsibility of maintaining a relationship with the taxpayer's primary customer. The employee engaged in no direct sales activity. Nevertheless, the presence of that one employee with very limited functions was found by the Court to constitute the "substantial" relationship contemplated by the nexus test.

The potential limits of this expansive holding are uncertain. There are trial court and administrative proceedings which apply *Standard Pressed Steel* to sale activities conducted by independent manufacturers' representatives. These cases find a "substantial nexus" whera an out-of-state taxpayer is represented within the state by an independent manufacturer's representative paid on a commission basis.[64] The application of *Standard Pressed Steel* to traveling employee representatives who spend minimal time within the state is also uncertain.[65]

The second requirement of the *Complete Auto Transit* test is that the tax in question be fairly apportioned. This requirement contemplates that the tax base against which the taxing jurisdiction seeks to impose a tax will be divided in some fair and structured way among the states with jurisdiction to levy a tax on the taxpayer. There is no requirement of absolute certainty in the apportionment process; a good faith effort to estimate apportionment ratios is sufficient.[66] It is clear, however, in a net income tax context, that where two states contribute to the economic consequences of a particular business activity, both states have some right to an apportioned segment of the taxing base and neither state has any exclusive right to tax 100% of any portion of that business income.[67] Apportionment in the gross receipts context has been stymied by the myopic, formalistic view that courts have taken of the typical multiactivity gross receipts tax.

The third prong of the *Complete Auto Transit* test prohibits discrimination against interstate commerce, whether the discrimination is intentional or unintentional.[68] If an activity in interstate commerce is taxed but a comparable local commercial activity is not, the tax would be struck down.

Finally, the *Complete Auto Transit* test requires that there be some "fair relation" between the tax and the services provided by the taxing authority. This test

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[63] Standard Pressed Steel Co. v. Washington, 419 U.S. 560 (1975).

[64] *E.g.*, Princess House, Wash. B.T.A. No. 18,818 (March 24, 1980).

[65] *See* Austin, Nichols Distilling Co., Wash. B.T.A. No. 19,549 (August 12, 1980).

[66] *See, e.g.*, Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983).

[67] *See generally* Mobil Oil Corp. v. Commissioner, 455 U.S. 425 (1980). Note, however, that *Mobile* left open the question of whether the state of a corporation's commercial domicile might constitutionally tax all of the corporation's net income, based on the theory that domicile carries with it special taxing privileges to the domiciliary state.

[68] *Cf.* Halliburton Oil Cementing Co. v. Reily, 373 U.S. 64 (1963).

has been construed very liberally. In *Japan Line, Ltd. v. County of Los Angeles*,[69] the Court was satisified with the taxing authority's assertion that the county offered "the benefits of a trained work force and the advantages of a civilized society" to the taxpayer.[70] Absent showing by the taxpayer that the tax burden vastly outweighs the benefit afforded by the taxing jurisdiction,[71] it seems likely that the "fairly related" test will not provide a substantial restriction.

In 1978, the *Department of Revenue of Washington v. Association of Washington Stevedoring Cos.*,[72] the Supreme Court expressly made *Complete Auto Transit* applicable to a state gross receipts tax strongly resembling that of the State of West Virginia. It appeared that under the "economic rationality" analysis in *Complete Auto Transit*, the characterization of a particular gross receipts tax as one which applies to only a particular level of activity (for example, sales) would no longer determine its constitutional validity. The fact that a tax was labeled a "manufacturing" tax rather than a "retailing" or "wholesaling" tax would not determine the outcome under the commerce clause. Instead, the economics of the tax in question would be considered. That expectation of economic rationality was not fulfilled in *Armco*.

IV. THE DECISION IN *ARMCO V. HARDESTY*

A. *Facts*

Armco, Inc. is an Ohio corporation whose primary business is manufacturing and selling steel products. During the tax years at issue, Armco conducted business in West Virginia through a number of separate divisions, only two of which involved West Virginia facilities and employees. The other three divisions were represented in West Virginia through franchisees or nonresident traveling salesmen.[73] The mental buildings marketed by the mental products division were sold in the State by two franchise dealers who resided there. The steel division and the wire rope division had no offices in the State but sold their products through nonresident traveling salesmen who solicited orders from West Virginia customers.[74]

West Virginia imposed a gross receipts tax on wholesale activities within the State.[75] The tax was measured by the gross income of the business and was applied

[69] Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979).

[70] *Id.* at 445.

[71] *See* Hans Rees' Sons, Inc. v. North Carolina *ex rel.* Maxwell, 283 U.S. 123 (1931) (state attempted to tax a substantially disproportionate amount of the taxpayer's income based on an apportionment formula which the court held would not stand constitutional analysis).

[72] *Stevedoring Cos.*, 435 U.S. 734.

[73] *Armco*, 104 S. Ct. at 2621 n.1.

[74] *Id.*

[75] 104 S. Ct. at 2621.

at the rate of 0.25% and later 0.27% during the years at issue.[76] An exemption from the wholesaling tax was provided, however, for those taxpayers who engaged in manufacturing or extracting natural resources in West Virginia and who also sold their products at wholesale.[77] Instead these taxpayers paid a manufacturing tax measured by the value of the products involved which was, in turn, measured by the gross proceeds of sales. During the tax years in question, the manufacturing tax was 0.80% and later 0.88% of the value of the products.[78] Local manufacturers and extractors, thus, did not pay the wholesaling tax but were taxed, at a significantly higher rate, under the manufacturing classification.

West Virginia sought to tax Armco on both its mining and sales activities in the State. Armco acknowledged the appropriateness of the tax on its West Virginia coal mining activities.[79] Similarly, Armco did not dispute the application of the wholesaling tax to the sales by the West Virginia employees of its metal products division.[80] It contested, however, the applicability of the wholesaling tax to the West Virginia sales of the steel division, the wire rope division and the sales of metal buildings by the franchisees of the metal products division.[81] With regard to those sales, Armco maintained no West Virginia manufacturing facilities, sales or other offices, inventories or resident employees. The orders for the sales of steel and wire rope were solicited in West Virginia by nonresident salesmen who visited the State periodically for that purpose.[82] All order were accepted outside West Virginia with title transferred to the purchaser outside the State.[83]

B. *Proceedings Below: Borrowed Nexus*

On audit of Armco's West Virginia business and occupation tax returns for tax years 1970 through 1975, the State Tax Commissioner took the position that Armco's West Virginia sales of steel and wire rope were properly taxable under the wholesaling tax. Armco sought a reversal of that additional assessment and a refund of taxes previously paid with respect to its sales of metal buildings on the basis that there was insufficient nexus between those sales and the state. The administrative appeal was denied, but the State Tax Commissioner was reversed by the Circuit Court of Kanawha County. The State, in turn, appealed to the West Virginia Supreme Court of Appeals. That court reversed, applying a "unitary business" analysis to Armco's West Virginia business activities and holding that where a taxpayer's unitary business had a substantial nexus to West Virginia, the Constitution does not require a nexus between the state and the specific activities taxed.[84]

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[76] 104 S. Ct. at 2621-22 nn.2-5.
[77] W. VA. CODE § 11-13-2 (1983).
[78] 104 S. Ct. at 2622 n.5.
[79] Armco, Inc. v. Hardesty, 303 S.E.2d 706, 708 (W.Va. 1983), *rev'd*, 104 S. Ct. at 2620 (1984).
[80] *Id.* at 709.
[81] *Id.*
[82] *Armco*, 104 S. Ct. at 2621.
[83] *Armco*, 303 S.E.2d at 708.
[84] *Armco*, 104 S. Ct. at 2622.

A brief review of the reasoning of the West Virginia Supreme Court of Appeals in applying this "borrowed nexus" analysis to Armco is instructive. It demonstrates the tension between the formalistic, semantic approach to commerce clause analysis of gross receipts taxes epitomized by the United States Supreme Court's decision in *Armco* and the attempts to develop a more practical analysis.

On appeal, Armco argued that there was insufficient nexus between its West Virginia sales of steel and wire rope products and metal buildings to allow West Virginia to tax those sales receipts. Armco claimed that each of its divisions must be treated separately for the purposes of establishing a taxing nexus with West Virginia.[85] Armco relied on *Norton Co. v. Department of Revenue of Illinois.*[86] In *Norton* the Supreme Court reviewed the attempt of the State of Illinois to apply its gross receipts tax to all Illinois sales of a Massachusetts manufacturer. The Court sustained the tax on sales made by the taxpayer's Illinois office and on sales in which that office acted as intermediary, but struck down the tax imposed on sales in which Illinois purchasers dealt directly and exclusively with the taxpayer in Massachusetts.

Instead of following *Norton*, the West Virginia Supreme Court of Appeals drew a parallel between the *Armco* case and *Exxon Corp. v. Wisconsin Department of Revenue.*[87] *Exxon* involved the application of the unitary business principle to affirm Wisconsin's application of its proportioned net income tax. The West Virginia court also drew on its own previous decisions sustaining a "borrowed nexus" analysis.[88]

Under the West Virginia court's analysis, Armco was "a unitary business corporation" conducting its business activity "under one corporate umbrella."[89] There was no need, therefore, to examine each of its income producing activities separately to determine whether in each instance there existed a sufficient connection to West Virginia to justify taxation.[90] In its efforts to examine the underlying economic realities of the situation, the court engaged in a certain degree of bootstrapping. Moreover, it ignored the problems inherent in applying a unitary business jurisdictional analysis to an unapportioned gross receipts tax. The West Virginia court's approach has a certain appeal to the extent that it attempts to treat the West Virginia gross income tax system, like a net income tax system, as one integrated system of taxation with an overall taxing goal. Because, however, the United States Supreme Court premised its decision in *Armco* on discrimination against interstate commerce, that Court found it unnecessary to reach the unitary business/borrowed nexus issue.

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85 *Armco*, 303 S.E.2d at 710.

86 Norton Co. v. Department of Rev. of Ill., 340 U.S. 534 (1951). *See* B.F. Goodrich Co. v. State, 38 Wash.2d 663, 231 P.2d 325, *cert. denied*, 342 U.S. 876 (1951); Indiana Dept. of Rev. v. J.C. Penney Co., 412 N.E.2d 1246 (Ind. App. 1980).

87 Exxon Corp. v. Wisconsin Dept. of Rev., 447 U.S. 207 (1980) (cited with approval in *Armco*, 303 S.E.2d at 709).

88 *See, e.g.*, Western Md. Ry. v. Goodwin, 282 S.E.2d 240 (W. Va. 1981), *appeal dismissed*, 456 U.S. 952 (1982); Cincinnati Milacron Co. v. Hardesty, 290 S.E.2d 902 (W. Va. 1982).

89 *Armco*, 303 S.E.2d at 714.

90 *Id.*

C. *The Court's Holding*

In reversing the West Virginia court, the Supreme Court based its eight-to-one decision on the second ground on which Armco had challenged the West Virginia tax scheme, namely that the West Virginia wholesale gross receipts tax unconstitutionally discriminated against interstate commerce. In an opinion by Justice Powell, the Court held that "West Virginia's wholesale gross receipts tax, from which local manufacturers are exempt, unconstitutionally discriminates against interstate commerce."[91]

This holding relates to the third of the *Complete Auto Transit* tests: to escape commerce clause invalidation, a state must not discriminate against interstate commerce. The Court provided a secondary basis for its decision by noting that Ohio (or any state where a manufacturing facility of Armco might exist) would have the right to levy a manufacturing tax on the local manufacturing activities of Armco. Under those circumstances, Armco would be required to pay both a manufacturing tax (in Ohio) and a wholesaling tax (in West Virginia) while West Virginia manufacturers selling in West Virginia would pay only the manufacturing tax. Although couched in the language of discrimination, this discussion suggests the multiple burdens test of *Western Livestock.*[92]

The Court's discrimination analysis follows *Boston Stock Exchange v. State Tax Commissioner.*[93] Under *Boston Stock Exchange*, a state "may not discriminate between transactions on the basis of some interstate element."[94] In the Court's view, the West Virginia statutory scheme permitted and in fact required the forbidden discrimination.[95] The West Virginia tax schemes provided that an out-of-state manufacturer selling in West Virginia would pay the wholesaling gross receipts tax. A West Virginia manufacturer selling to a West Virginia resident would pay a manufacturing tax but no tax at the wholesaling level. The net effect of this scheme was that two manufacturers selling at wholesale in West Virginia would be treated differently depending on whether the manufacturing was done in West Virginia. No wholesaling tax would be applied to the sale of the West Virginia-manufactured product while a product manufactured outside the State would be subject to the wholesaling tax.

The Court rejected the analysis of the court below that discrimination did not exist because local manufacturers paid a tax on their manufacturing activity that was more than three times the rate of the wholesaling tax. The Court refused to engage in an analysis involving the comparison of taxes on various levels of business

[91] *Armco*, 104 S. Ct. at 2621.
[92] *Western Livestock*, 303 U.S. 250.
[93] Boston Stock Exch. v. State Tax Comm'r, 429 U.S. 318 (1977).
[94] *Id.* at 329.
[95] *Armco*, 104 S. Ct. at 2624.

activities, holding that: "The gross sales tax imposed on Armco cannot be deemed a 'compensating tax' for the manufacturing tax imposed on its West Virginia competitors."[96] The rationale for this refusal was "[m]anufacturing and wholesaling are not 'substantially equivalent events' such that the heavy tax on in-state manufacturers can be said to compensate for the admittedly lighter burden on wholesalers from out-of-state."[97]

The Court acknowledged that in-state manufacturers frequently sell in-state, but opined that it was not possible to determine the portion of a tax imposed at the manufacturing level that is attributable to manufacturing activities as compared to the portion attributable to wholesaling activities.[98] The Court noted that the West Virginia manufacturing tax was not reduced when a West Virginia manufacturer sold out-of-state. The fact that the tax was reduced proportionately when part of the manufacturing took place out-of-state was viewed by the Court as evidence that the West Virginia manufacturing tax was not structured to compensate for the exemption from the wholesaling tax.[99]

The Court rejected the notion that Armco was required to establish actual discrimination. It was not necessary to show that Armco paid a manufacturing tax in Ohio and that the imposition of that manufacturing tax resulted in an actual tax burden higher than the tax burden imposed on West Virginia manufacturers. Instead, in the face of a claim of discrimination, a tax must have "what might be called internal consistency—that is the [tax] must be such that, if applied by every jurisdiction there would be no interference with interstate commerce."[100] The Court noted that a rule requiring the taxpayer to establish actual discrimination would depend on the vagaries of state and local legislative discretion, the complexities of the tax codes in each of the other forty-nine states, and the thousands of local jurisdictions whose taxes are subject to the commerce clause principles.[101]

In an apparent "belt and suspenders" line of reasoning, the Court noted that if Ohio (the state of manufacture) had imposed a manufacturing tax, then Armco would have paid both a manufacturing tax to the State of Ohio and a wholesaling tax to the State of West Virginia. West Virginia manufacturers, meanwhile, would have paid only the manufacturing tax to their home state.[102] Although the Court noted this potential multiple burden in the context of establishing a discrimination, the logic of including this argument is not clear. Discrimination does not depend on whatever tax system another state or local jurisdiction might establish; it depends

[96] *Id.* at 2623.
[97] *Id.*
[98] *Id.*
[99] *Id.*
[100] *Id.* at 2624 (citing *Container Corp. of Am.*, 463 U.S. 159 (1983)).
[101] 104 S. Ct. at 2623-24.
[102] *Id.* at 2624.

upon the effect of the taxing scheme of the jurisdiction which is under taxpayer attack. Discrimination cannot be established by reference to what others do but instead must be established by reference to the actions of the taxing authority which are under challenge.

D. *The Dissent*

Justice Rehnquist's dissent accepted an argument raised by the West Virginia State Tax Department. If actual rather than hypothetical tax burdens were examined, a West Virginia manufacturer paid a gross receipts tax to the state at a rate substantially higher than the rate imposed on out-of-state manufacturers wholesaling into the state.[103] The state cited *Halliburton Oil Well Cementing Co. v. Reily*[104] to the effect that proper discrimination analysis must take "the whole scheme of taxation into account," and that "equality for the purposes of competition and the flow of commerce is measured in dollars and cents, not legal abstractions."[105] The dissent agreed and determined to examine "the State's tax structure as a whole." Under that analysis it was "plain that West Virginia has not created a tax granting a direct commercial advantage to local businesses."[106] In the reasoning of the dissent, the in-state manufacturers' tax incorporates the tax levied on wholesale activity, with the result that the overall tax burden is proportionate to the commercial activity actually engaged in.

Justice Rehnquist notes that the majority adopts a formalistic approach to the commerce clause analysis of a gross receipts tax that is contrary to the teaching of *Complete Auto Transit, Inc. v. Brady*.[107] In his view, the economically realistic approach mandated by *Complete Auto Transit* would require that the West Virginia tax scheme be upheld as applied.

V. THE OPPORTUNITY MISSED: ECONOMICALLY RATIONAL ANALYSIS

Complete Auto Transit prescribes an economically rational examination of the impact of a particular state tax as well as an examination of the relationship between the governmental entity seeking to impose the tax and the taxpayer. Four discrete criteria which together were to determine whether the commerce clause invalidates a state tax were put forward by the Court. The *Complete Auto Transit* analysis has been made applicable to gross receipts taxes by *Department of Revenue of Washington v. Association of Washington Stevedoring Companies*.[108] In *Armco*,

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[103] *Id.* at 2625-26.
[104] *Id.* at 2625 (citing *Halliburton* 373 U.S. 64, n.60).
[105] Brief for Appellee at 79, *Armco*, 104 S. Ct. at 2620 (1984).
[106] *Armco*, 104 S. Ct. at 2625.
[107] *Complete Auto Transit*, 430 U.S. 274 (1977).
[108] *Stevedoring Cos.*, 435 U.S. 734.

the Court ignored its own prescription and missed an opportunity to advance commerce clause analysis of gross receipts taxes to the same level of rationality and predictability as exists for analysis of net income taxes.

The *Armco* Court, followed precedent but ignored its own prohibition on economically meaningless and purely formalistic tests,[109] when it characterized the West Virginia gross receipts tax system as consisting of separate taxes imposed on separate specific events, that is, wholesaling and manufacturing. This semantics-oriented analysis leads to the erroneous conclusion that a gross income tax imposed on one activity at a particular level bears no relationship to another business function of the same taxpayer that might be taxed at another level. It also justifies imposing a tax on interstate activities that may bear no real relationship to the values attributable to the taxing state. The inadequacies of this approach to commerce clause analysis led to *Complete Auto Transit*. It focuses on draftsmanship rather than economic substance and is, for that reason, outmoded.

The tax at issue in *Armco* should have been characterized as what, in substance, it is: a tax on some level of "doing business" exactly like a net income tax or a capital stock tax. A gross receipts tax bears all the indicia on other "doing business" taxes. First, it is broadly indexed on the net profitability of the business taxed. As indicated earlier, most states that impose a gross receipts tax impose the tax at a higher or lower rate depending on the presumed profitability of the business activity taxed.[110] Although the relationship to overall profitability may vary for specific businesses within an industry, the thrust of the tax policy remains clear.

Further, states that employ gross receipts taxes create exemptions, deductions, and credits[111] similar to many of the policy-oriented exemptions permitted in net income taxes. Certain governmental, charitable and civic activities, for example, are exempted from tax.[112] Business activities which the state seeks to foster are often exempted,[113] while activities viewed with disfavor are taxed at high rates.[114] The recognition that a gross receipts tax is in substance economically similar to the net income tax would facilitate an economically realistic commerce clause review of such taxes. Instead of focusing on the label of the tax, the analysis would focus on whether imposition of the tax on a taxpayer in interstate commerce, at *whatever* level of business activity, taxes only that portion of the taxpayers' receipts fairly attributable to the taxing state.

The overall commercial activities of a multi-state business are likely to receive

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[109] *Complete Auto Transit*, 430 U.S. at 284-85, 288.
[110] *See supra* note 7 and accompanying text.
[111] *See supra* notes 14-23 and accompanying text.
[112] *See supra* notes 15-16 and accompanying text.
[113] *See supra* note 19 and accompanying text.
[114] *See* WASH. REV. CODE § 82.04.260(a) (1983), under which businesses involved in the disposition of low level nuclear waste are taxed at very substantial rates.

support from branches or offices situated in a number of different taxing jurisdictions. The headquarters group located in one state might assist a manufacturing facility in a second state and a wholesaling office in a third state. All might be aided by a lobbying group located in Washington, D.C. and by a finance and economic forecasting group located in New York. The notion that the parts of the corporate organism all contribute to the business effort is recognized in the net income tax context and is the source of the standard apportionment formula in the Multi-State Tax Compact.[115] It reflects a determination that a particular taxpayer is, in effect, engaged in one integrated business process which might properly be subjected to a fairly apportioned tax in each of the localities where there is some function which contributes to that integrated business activity.

Under the formalistic, single-level analysis of *Armco* and its predecessors, it is impossible for those states which levy gross receipts business taxes rather than net income taxes to tax the business activity properly attributable to that state. Yet, as we have suggested, there is little difference in the overall economics of a gross receipts "doing business" tax and a net income "doing business" tax. If the *Armco* Court had proceeded on an economically rational basis, an acknowledgement of the parallels between a gross receipts tax and a net income tax might have been drawn, and an economically rational system of determining the constitutional validity of West Virginia's taxing scheme could have been employed.

If the court had utilized the four criteria of *Complete Auto Transit*,[116] the West Virginia tax might have been sustained. First, there was no contention in *Armco* that the taxpayer on an overall basis had insufficient nexus with West Virginia (although there was a strongly argued contention that certain activities of Armco, taken individually, did not give rise to jurisdiction). Nor was it argued that the tax in question bore no relationship to services provided within the taxing jurisdiction. The Court determined that the taxing scheme was discriminatory. If it had employed *Complete Auto Transit's* analysis, however, it would have determined that there was no real discrimination against out-of-state manufacturers who were taxed at less than one-third of the rate applied to in-state manufacturers. Finally, the Court did not address the apportionment issue. If the statutory scheme had provided a mechanism for apportionment, however, it is likely it would have been upheld.

Here again, an acknowledgment of the parallels between gross receipts and net income taxes is instructive. For net income taxes, the constitutional apportionment requirement has extreme vitality. In the area of gross receipts and severance taxes, however, the consequences of the apportionment test are less clear. As discussed earlier, *General Motors* sanctioned the application of a gross receipts tax

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[115] *See e.g.*, OR. REV. STAT. §§ 305.655 (1983); WASH. REV. CODE § 82.56.010 (1983); W. VA. CODE § 11-10A-1 (1983) (Multi-State Tax Compact).

[116] *Complete Auto Transit*, 430 U.S. 274.

on a destination basis without attribution of revenues to the state of origin.[117] Most gross receipts tax states reciprocate by declining to tax interstate sales which originate in the state. Service income is sometimes apportioned. The State of Washington, for example, statutorily recognizes the validity of apportionment with respect to service activities conducted within and without the state.[118] Because no such notion has been applied in the sales context, many states respond to the destination/origin concept by merely taxing some underlying component of the taxpayer's business, be it manufacturing or extracting. This is the case in Washington and West Virginia.

Nevertheless, the economic analysis mandated by *Complete Auto Transit* strongly suggests that the rejection of an apportionment requirement for gross receipts taxes on interstate transactions should no longer be the rule. Apportionment reasoning might well be utilized by the Supreme Court in ascertaining the validity of a gross receipts tax on wholesaling or manufacturing activities in the face of a commerce clause attack. The Court has allowed the broadest possible latitude in ascertaining the validity of an apportionment scheme utilized in the context of a net income tax.[119] That latitude should be afforded the taxing authority in gross receipts tax review. In the area of net income taxes, the Court places a substantial burden on the taxpayer to show that the apportionment method is not "fair." No less a burden is appropriate for gross receipts taxes.

A. *Implications For Other States*

The West Virginia statutory scheme tested in *Armco* imposed a manufacturing tax on West Virginia manufacturers, whether their product was exported to another state or country, or sold to a purchaser within the state. No wholesaling tax was imposed on the West Virginia manufacturer-seller. The Court concluded that the West Virginia wholesaling tax could not constitutionally be imposed on an out-of-state manufacturer selling in West Virginia because no tax denominated a "wholesaling" tax was imposed on West Virginia manufacturers-sellers. This label-oriented approach to commerce clause review could, if consistently applied by the Court, have significant repercussions on the taxing schemes of other jurisdictions.

The State of Washington, for example, has a gross income tax scheme for taxing manufacturer-sellers which is the mirror image of the West Virginia scheme. That is, a Washington manufacturer who sells to Washington purchasers pays a wholesaling (or retailing) tax (but no manufacturing tax) on the gross proceeds of those sales.[121] Similarly, an out-of-state manufacturer selling into Washington

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[117] *General Motors,* 377 U.S. 436. Since only in-state receipts are taxed, the receipts are perfectly apportioned. But, as discussed at note 108 and accompanying text, many offices of the taxpayer may have contributed to the sale and an apportionment scheme that fails to recognize this is flawed.

[118] *See* WASH. REV. CODE § 82.04.460 (1983).

[119] *See generally Mobil Oil,* 445 U.S. 425.

[120] *Id.*

[121] WASH. REV. CODE § 82.04.440 (1983).

is taxed on its retail or wholesale sales.[122] A Washington manufacturer who exports its products to another state or foreign country, on the other hand, pays a manufacturing tax measured by the gross value of the product exported.[123] Thus, when comparing the tax on two Washington manufacturers, one that exports its product and one that sells its product in Washington, the exporter pays the "manufacturing" tax while the domestic seller pays a "wholesaling" tax. The inverse of the *Armco* taxpayer's successful discrimination argument can be utilized by the Washington manufacturer for export: its export activity is the subject of discrimination because no manufacturing tax is borne by the manufacturer for domestic sale.

The argument appears valid in the context of the *Armco* decision. If judicial review under the commerce clause concentrates only on the single level of taxation being challenged, then it is clear that the Washington export manufacturer pays a tax while the domestic-consumption manufacturer does not. If no argument is permitted with respect to compensating taxes at different levels of business activity, the conclusion is inescapable that a system of discrimination exists. The Washington manufacturing tax is currently the subject of refund challenges in a number of cases filed shortly after the *Armco* decision was announced.[124] No case has yet been decided, although it is the expectation of the parties that one of these cases will ultimately reach the United States Supreme Court. In response to the *Armco* decision, the Washington State Department of Revenue will submit to the legislature a bill suggesting a number of changes in the taxing scheme.[125] The effect of those requested changes is satisfying a constitutional challenge is in doubt.[126] Because of the substantial number of dollars involved in the refund of Washington manufacturing tax claims,[127] and in suits anticipated in other jurisdictions, the issue is one of extreme importance to any state or local government that depends on a gross income tax as a stable source of revenue.

B. *A Suggested Approach*

An economically rational judicial review of the application of a gross income tax to a particular interstate taxpayer should grant to the state the presumptions of constitutionality that have been afforded the net income tax. The legislature

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[122] WASH. REV. CODE § 82.04.270 (1983).

[123] WASH. REV. CODE § 82.04.240 (1983).

[124] *See, e.g.,* Eldec Corp. v. Department of Rev. of Wash., No. 84-2-01858-2, (Thurston Cty. Sup. Ct. 1984).

[125] S.B. 4228 (1985 Wash. Legis., 1st Sess). The bill calls for a credit to be applied against the Washington manufacturing tax for a wholesaling or retailing gross receipts tax paid by a Washington manufacturer to other state taxing authorities. Its constitutionality under *Armco* remains uncertain.

[126] *See, e.g.,* Xerox Corp. v. Department of Rev. of Wash., No. 84-2-01916-3 (Thurston Cty. Sup. Ct. 1984).

[127] The Department of Revenue of the State of Washington estimates that for years 1980 through 1984 approximately $500,000,000 of taxes are at issue. *Id.* (Affidavit of Gary O'Neil).

would be presumed to have utilized a rational thought process in establishing the level and rate of tax which might appropriately be due from a particular taxpayer. With that presumption of legislative validity, the West Virginia tax in *Armco* would have been upheld. The tax rate for Armco's wholesaling activities was 0.27%, a rate less than one-third the tax which was imposed on manufacturers located within the state. The Court might well have determined that the West Virginia legislature exercised a rational process of decision making in setting the rate on a smokestack industrial activity at a substantially higher rate than on an activity for which the manufacturing component was conducted elsewhere. This analysis would allow the basic nature of the business to be characterized by the legislature, and then, armed with the judicial presumption of validity, the tax might have been allowed to stand.

Legislatures could assist in this process by establishing a credit or some adjustment with respect to export or import activities. For example, had the West Virginia statutory scheme permitted an apportionment adjustment of the tax base at the manufacturing level when the product is exported, the State might then logically have argued that an adjustment was made in the taxing scheme where no wholesaling activities were conducted in West Virginia. Where wholesaling activities were conducted in the state, the full manufacturing tax would be imposed.

Application of the *Complete Auto Transit* analysis would mandate a realistic analysis of the apportionment of any gross receipts tax on interstate business activity. That analysis would preclude the current situation in which a taxpayer with activities in three jurisdictions, all of which contribute to one integrated business activity (*e.g.*, extraction, manufacture and sales), could theoretically be taxed virtually to the extent of 100% of the gross sale proceeds in each of the three states involved).[128]

An economically realistic approach to the apportionment of gross receipts of sales for a taxpayer engaged in activities in several states is to view that activity as sufficiently integrated to give rise to an apportionable overall tax base. Even sales and manufacturing activities in more than one jurisdiction could be viewed as sufficiently integrated to give rise to apportionment.

Various methods of apportionment could be utilized. One of these is the three-factor formula method mandated by the Multistate Tax Compact.[129] Such a formula has already been utilized in connection with gross receipts taxes on finance company income.[130] Another alternative is to apportion on a cost basis. That ap-

[128] Under the court's reasoning in *Armco*, a business which extracts a raw material in the State of Washington, manufactures it into a product in Indiana and sells it to residents located in West Virginia would pay a gross receipts tax on 100% of the value of the extracted product to the State of Washington, 100% of the value of the manufactured product to the State of Indiana and 100% of the value of the product as sold to the State of West Virginia.

[129] *Supra* note 115.

[130] *See* Pacific First Fed. Sav. & Loan Ass'n v. Washington, 92 Wash.2d 402, 598 P.2d 387 (1979).

proach has been sanctioned for use in Washington in certain situations.[131] If the *Complete Auto Transit* analysis is to be applied in more than a superficial manner, some form of apportionment is mandated.

CONCLUSION

In deciding *Armco v. Hardesty*, the United States Supreme Court returned to the artificial analysis applied historically to gross receipts taxes. In this traditional analysis, a tax on any particular level of business activity is judged in isolation from the economic realities of the taxing jurisdiction's entire tax scheme. Such an analysis disregards provisions for compensating taxes or apportionment of revenues attributable to multiple jurisdictions. This approach ignores the more economically rational and legally defensible analytical tools utilized in reviewing net income tax schemes. Application of the four-factor analysis enunciated in *Complete Auto Transit* would allow a realistic analysis of whether a state has attempted to tax more than its proportionate share of interstate business activities. Hopefully, the Court will soon return to such a realistic analysis of gross receipts taxes, thus leaving the *Armco* decision as a mere aberration in the Court's development of commerce clause analysis of state tax systems.

[131] WASH. REV. CODE § 82.04.460(2) (1983).